Exhibit A

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Tuesday, June 17, 2008

So How Did Lehman Delever? A Not-Very-Pretty Possibility

The markets responded positively today to Lehman's announcement of its second quarter results, its provision of a financial supplement that gave more detail on its balance sheet exposures and how they had changed over time, and its investor conference call, The stock was up over 5% of the day, although its closing price of $27.20 is still below the offering price last week of $28.00.

One of the problems with the conference call format is that the balance sheet is not available until the 10-Q is filed. For most companies, the balance sheet is not where the action is, but financial firms are an exception, particularly in trying times. So the analysts miss the opportunity to grill management on the really meaty stuff. Admittedly, there was a page in the Lehman press release that contained leverage computations, and the supplement did provide a good deal of detail on certain types of exposures. But as Michael Mayo of Deutshce Bank pointed out during the Q&A, it's hard to know what to make of those figures without having the carrying values (as in average markdown). And even with the detail, several analysts asked for more breakdowns which Lehman said it would provide to them.

First, we'll deal with a few anomalies, then we'll get to what is admittedly a rumor, but one if true with pretty serious implications.

The preliminary announcement indicated that Lehman's reduction in gross assets was $130 billion and net was $70 billion; today, the gross figure was $147 billion. Figures can move around while statements are being finalized, and the gross number is probably less important than the net.

The marks on the now-somewhat-notorious SunCal deal (largely raw land) is 70 cents on the dollar. Land, which in a negative carry item (you have to keep paying taxes) is very much a "beauty is in the eye of the beholder" asset unless you have developed properties nearby to give a benchmark. I'm not clear what stage this project is in (the plan was to subdivide, develop, and sell lots, so the "development"

consists of getting roads and utilities in). However, the Wall Street Journal indicated that land values in the area have fallen by as much as 60%. Lehman's exposure is senior debt, and a mark in the mid-70s seems a tad aggressive (um, where is the cashflow to service debt? Mid-70s seems high for an asset that by its demographics is probably non-performing). This is not a large exposure ($1.6 billion gross), but it is one David Einhorn discussed, and taking what appears to be a generous valuation on a high-profile position raises unnecessary questions.

Another oddity is compensation expenses. They rose $418 million ($130 of that was severance) when headcount fell by 1,900.

A further question mark is Level Three assets. They fell on a gross level from $40 billion to $38 billion, but when you decompose that, Lehman sold $3 billion of assets in the Level 3 bucket, wrote down $2 billion, and then added another $3.5 billion. That might not seem so bad were it not for this statement from Dick Fuld in the conference call:

> We had the benefit of much greater price visibility due to the number of assets that were sold especially in the commercial and residential mortgage area that were the result of our deleveraging and the strong trading volumes in the cash, and then certain derivative markets that gave us important additional valuation information.

If they had a much better sense of market values, particularly in the sometimes thorny derivatives arena, one would have expected some assets to be moved out of Level 3 via having market reference points, as opposed to by offloading them or reducing their values. But that appeared not to have happened.

The last, looming mystery is how Lehman delevered in a crappy credit market. Their quarter ended in May, and March, thanks to the Bear meltdown and the worries about Lehman, would not have been a good time to sell assets. Similarly, one would have expected sales to be concentrated in certain sectors of the market where pricing was more favorable. Lehman went to great pains to show that the sales were spread across product and said they were not concentrated in the highest credit qualty assets either. They also said sales were spread over the quarter (given March, I find that to be quite a statement).

This seems to be too good to be true, and begs the question I raised when Lehman first began talking up its delevering via CNBC: were these really arm's length sales, or, as has happened with a lot of leveraged loans and some Alt-A portfolios, were they financed? Note no analyst raised this issue in the conference call.

I received an e-mail from a former Lehman MD yesterday. I am not able to independently verify it, so be warned that this falls in the category of a rumor. Nevertheless, it is sufficiently specific that it sounds credible to me, and it explains the mystery of how Lehman was able to distribute its sales so well across its various types of holdings and not take any apparent big hits to tidy up its balance sheet (even if you have marked an asset at a defensible price, the offer for, say, $5 million in assets is gong to be higher than if you are trying to unload $500 million, and thus you could take a loss on a supposedly conservative mark if you get serious about reducing exposures in a wobbly market).

The message:

> Curious whether, to your knowledge, they've given much detail around the reduction in gross & net leverage they achieved in the May qtr. My understanding is that the vast majority of the reduction came from spinning out two large businesses into independent entities: the mortgage trading business (now called "One William St Capital") and the

> principal investing business (now called "R3 Capital"). R3 Capital is starting life with assets of around $55 billion.
>
> From friends both inside & outside LEH, I understand that LEH is keeping a 45% stake in each business. They are continuing to vest stock for former LEH employees who join the new ventures (so LEH is effectively paying much of their compensation…this may be why LEH's compensation expense spiked in the May qtr). LEH's continued economic interest in the two entities has been described to be as "complex" (ie, it's not as simple as 45% carried interest in profits or losses). The main driver, unsurprisingly, was to allow LEH to maintain as much econ interest as possible, consistent with meeting accounting standards to get the biz's off LEH's balance sheet.
>
> I haven't spoken to anyone who has had much to say either way about whether (& to what extent) LEH would face contingent liabilities in the event the new entities were counterparties to losses…but it's not that hard to imagine a situation where either of these two entities faced losses from derivatives contracts that exceeded (by a wide margin) the capitalization of the newco's. Will the counterparties, in those cases, look to LEH as a backstop? How could they not?
>
> Anyway, perhaps LEH has given adequate disclosure on this today, and if so my concerns are moot.

I read the conference call transcript and the filings today and saw no reference of asset sales to new entities.

Now if this is indeed accurate, and comes out at some future point, I'd be pretty unhappy if I were an analyst. Given the recent history with Bear Stearn's failed hedge funds and SIVs, financial firms have had a pretty hard time not supporting off-balance sheet businesses and sponsored entities when they run aground. And if Lehman managed to maintain a 45% economic interest while getting an off balance sheet treatment (their accountant must be some sort of evil genius), it would be even harder for them not to step up in the event of mishap.

If true, and I stress if true, this stinks to high heaven. But given that Lehman played fast and loose with SEC Rule FD, this would be another instance of questionable business practices.

Anyone who can corroborate or deny is very much encouraged to speak up.

Topics: Investment banks, Regulations and regulators

Email This Post Posted by Yves Smith at 3:43 am

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- *Anonymous* says:

June 17, 2008 at 4:32 am

Hmm… seems a curious coincidence given that their prime brokerage business has been booming. The alleged spawning even yields fees for them which they can promptly book.
My mind also raced as they described that the recent largesse of PB was a result of the new conditions in financing. Is this because they offering the hedgies securities to the Fed gods at 2%, only to charge Libor++? Seems that not everyone is being disadvantaged by the divergent Libor rates now that Ibanks have that special borrowing power window opened up to them…

- *eh* says:
June 17, 2008 at 5:27 am

You don't learn much by googling the name — 'One William St Capital'. I did find this Bloomberg article from back in March, which states that a veteran of LEH is starting this new company:

Sherr, a 21-year Lehman veteran who most recently ran the firm's securitization group, is starting One William Street Capital Management LP after Peloton Partners LLP and Sailfish Capital Partners LLC collapsed because of losses in the credit markets… "The timing is great because the market dislocations create opportunities and have shaken out a lot of very good talent," said Patric de Gentile-Williams, chief operating officer of FRM Capital Advisors Ltd., a London-based firm that seeds hedge funds. "Some guys on Wall Street prop desks who feel like their capital has been cut are looking at making the leap to setting up their own business." …Sherr, 44, expects to start by June with more than $1 billion, ***including backing from his former employer****, said people with knowledge of his plans, who declined to be identified because fundraising hasn't been completed.*

If the email you got is accurate, then this Bloomberg piece is somewhat misleading; so there could be good reasons why some people did not want to be identified when commenting.

- *Richard Kline* says:
June 17, 2008 at 5:44 am

Sooo, some real, ah, problem centers aren't really gone from LEH, they're out in the back forty up on blocks and under a big tent. One William, a mortgage trading concern, methinks with crumbling blocks they would dearly like to trade. R3 sounds like its a gin for derivatives sitting on large counterparty swaps o' the same . . . the kind of 'assets' which may not pay out at all.

This recalls to mind, should it be true, of the plan proposed for the monolines, to, somehow, split their liabilities into one firm and their insurer into another firm, and 'then everything will be fine.' Oo-laah. I just don't see Lehmans being here a year from now.

- *Anonymous* says:
June 17, 2008 at 5:51 am

google R3 Capital Partners and see what links you get:

http://www.ustreas.gov/offices/domestic-finance/debt-management/adv-com/members/

Office of Debt Management
Treasury Borrowing Advisory Committee Members

VICE CHAIRMAN
Rick Rieder
President/CEO
Head of Global Principal Strategies
R3 Capital Partners
1271 Sixth Avenue, 39th floor
New York, NY 10020

What a great set-up welcome package! You get capital, employees paid for, assets for your book and, a plum seat on a treasury committee!

ok, to be fair, the guy held the seat while he was at LEH 3 months ago too….

- *S* says:

June 17, 2008 at 6:22 am

Also,
LEH financing about 20% of the CMBS sales with “onerous terms”
LEH packaging whole loans in euorpe to increase their liquidity (i.e dump at the central Bank)

The compensation accrual is a bit puzzling, even ex the restructuring of $100M or so. Also, your point on marks is well taken. The UK mortgage portfolio is marked in the low 80s even though they went to great pains to say how it is priced for a 28% distress scenario.

- *Anonymous* says:

June 17, 2008 at 7:06 am

Isn’t this similar to an SIV? Would Lehman mark its stake in those spin-offs as level III?

- *Anonymous* says:

June 17, 2008 at 7:16 am

Nice post. It would be amazing if LEH utilized(abused) a SIV-like transaction in today’s environment. Please stay on top of this, as the facts play out, so we can connect the dots. It gives great satisfaction when someone pulls the curtain back on a chareleton(if that turns out to be the case)and exposes the ruse while their still in the act.

Anonymous @6:51am

It’s a debt management advisory committee. Looks like all the Committee members are hedge fund/inventment company people. How much clout could this committee really have?

- *Anonymous* says:

June 17, 2008 at 7:19 am

Sorry for the typo’s in the prior post

their= they're
inventment= investment

Will do better next time.

- *Anonymous* says:
June 17, 2008 at 7:37 am

Anon at 8:16:

Isn't that a list of the plunge protection team?

- *Anonymous* says:
June 17, 2008 at 8:08 am

A quick check at wikepedia shows the "Plunge Committee" group includes the Fed Chair, someone from the SEC and a few other government officials. The advisory committee referenced above doesn't seem to include any of those government folks.

- *cdulan* says:
June 17, 2008 at 10:00 am

Great posts people. More about Rick, his posted profile says he was a LEH exec from 2004 – 2007.

http://center.spoke.com/info/p2jMU3x/RickRieder

- *Nicholas Mycroft* says:
June 17, 2008 at 10:14 am

R3 Capital is also a hedge fund started recently by a former LEH employee. If you want to pursue further, I would start here:

http://www.dtcc.com/downloads/legal/imp_notices/2008/dtc/com/3433-08.pdf

- *John* says:
June 17, 2008 at 10:22 am

An analyst might want to contact them:
http://onewilliamstreet.com/

- *Anonymous* says:
June 17, 2008 at 10:25 am

well the guy was quoted in a bberg "plunge protection" article as working for LEH as/at March 19 of

this year:

"'Every day the markets are full of rumor and trivia, and he has an ability to cut through that and get to what is the heart of the problem,' said Rick Rieder, managing director and head of Global Principal Strategies at Lehman Brothers Holdings Inc., who serves as vice chairman of the Treasury's bond borrowing advisory committee."

http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aSGeeYac8Pd8

Paulson's Surrogate Steel Sees Early Market Progress

- *Anonymous* says:
June 17, 2008 at 12:09 pm

The R3 and One William Street accusation appears to be a false rumor. These are both run by former Lehman guys, and were set up awhile ago. R3 focuses on liquid corp. bonds, not resi, comml. mtg, or Levgd loans. So they wouldn't be buying those assets. One William Street is tiny (~$200 mil.) and couldn't have even put a tiny dent in Lehman's massive problem asset sale.

Also, Lehman did shift assets to L2 from L3…the net was toward L3, thanks to UK mortgage, but they did shift U.S. resi and comml. mtg to L2

- *Anonymous* says:
June 17, 2008 at 1:08 pm

Actually, both R3 and One William Street launched in May of this year, both are run by ex-Lehman sr execs,and Lehman has a significant stake in each. Incidentally, One William Street was the address of Lehman's headquarters from the 1920's to the 1970's, so the name clearly suggests a significant Lehman connection.

- *Michelange Baudoux* says:
June 17, 2008 at 1:42 pm

On the rumor radar, an even less pretty idea : X is to LEH what JPM is to BSC : a reverse investor :

http://bankimplode.com/blog/2008/06/15/lehman-brothers-is-another-jp-morgan/

- *Anonymous* says:
June 17, 2008 at 1:45 pm

The Lehman connection is not in doubt at all. But that doesn't mean LEH unloaded the problem assets on them.

Now if they had a couple of billion, lots of leverage extension, the right expertise, and the willingness to crater their reputations as asset mgrs right out of the box….

- *Anonymous* says:
June 17, 2008 at 9:11 pm

It's a variation of 3 card monte. Still, who's going to do anything about it? Any regulating body in oversight?? gimme a break. They all have skin in the deceit so there's a snowball's chance in hell they'll force the issue. Goldman Sachs is also doing something similar to unload its Cheyene position.

- *doc holiday* says:
June 18, 2008 at 12:09 am

Rick Rieder, head of Lehman Brothers' proprietary investment strategies, is raising assets for a hedge fund that will invest in fixed income securities, according to people familiar with the matter.

Lehman Brothers will be a significant but a minority investor in the fund, dubbed R3 Capital Partners, which Mr Rieder hopes to launch at the end of the month.

Lehman executive in fund launch

http://www.ft.com/cms/s/0/7af12b70-1c89-11dd-8bfc-000077b07658,dwp_uuid=a58b7ee6-1c23-11dd-8bfc-000077b07658.html?nclick_check=1

- *doc holiday* says:
June 18, 2008 at 12:27 am

The following is an excerpt from a 10-Q SEC Filing, filed by LEHMAN BROTHERS HOLDINGS INC on 10/10/2006

http://sec.edgar-online.com/2006/10/10/0001104659-06-065900/Section2.asp

Mortgages and mortgage-backed positions include mortgage loans (both residential and commercial), non-agency mortgage-backed securities and real estate investments held for sale. We originate residential and commercial mortgage loans as part of our mortgage trading and securitization activities and are a market leader in mortgage-backed securities trading. We securitized approximately $102 billion and $94 billion of residential mortgage loans for the nine months ended August 31, 2006 and 2005, respectively, including both originated loans and those we acquired in the secondary market. We originated approximately $45 billion and $65 billion of residential mortgage loans for the nine months ended August 31, 2006 and 2005, respectively. In addition, we originated approximately $27 billion and $18 billion of commercial mortgage loans for the nine months ended August 31, 2006 and 2005, respectively, the majority of which has been sold through securitization or syndication activities. See Note 3 to the Consolidated Financial Statements for additional information about our securitization activities. We record mortgage loans at fair value, with related mark-to-market gains and losses recognized in Principal transactions in the Consolidated Statement of Income.

At August 31, 2006 and November 30, 2005, we owned approximately $8.9 billion and $7.9 billion, respectively, of real estate held for sale. Our net investment position after giving effect to non-recourse financing was $6.2 billion and $4.8 billion at August 31, 2006 and November 30, 2005, respectively.

- *Anonymous* says:

June 18, 2008 at 9:17 pm

The WSJ reported that Sherr was fired from LB in Sept of last year…now he's their golden goose???

And as for prime brokerage booming, it would be perilous from a legal/compliance perspective for Lb to act as prime broker for a hedge fund in which it was such a significant investor. Bear Stearns, Ralph Cioffi-type, conflicts of interest, anyone? Nobody ever learns. And to the comment above, no one at the regs seems to be watching, or to care.

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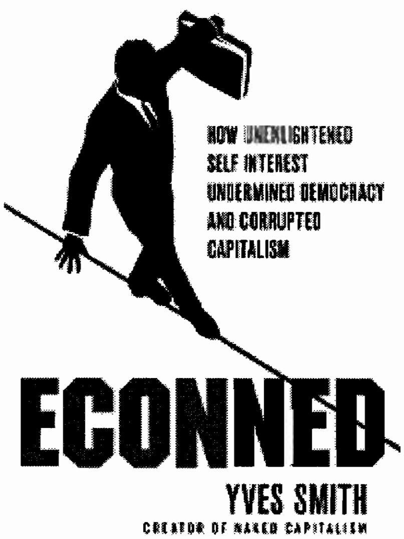

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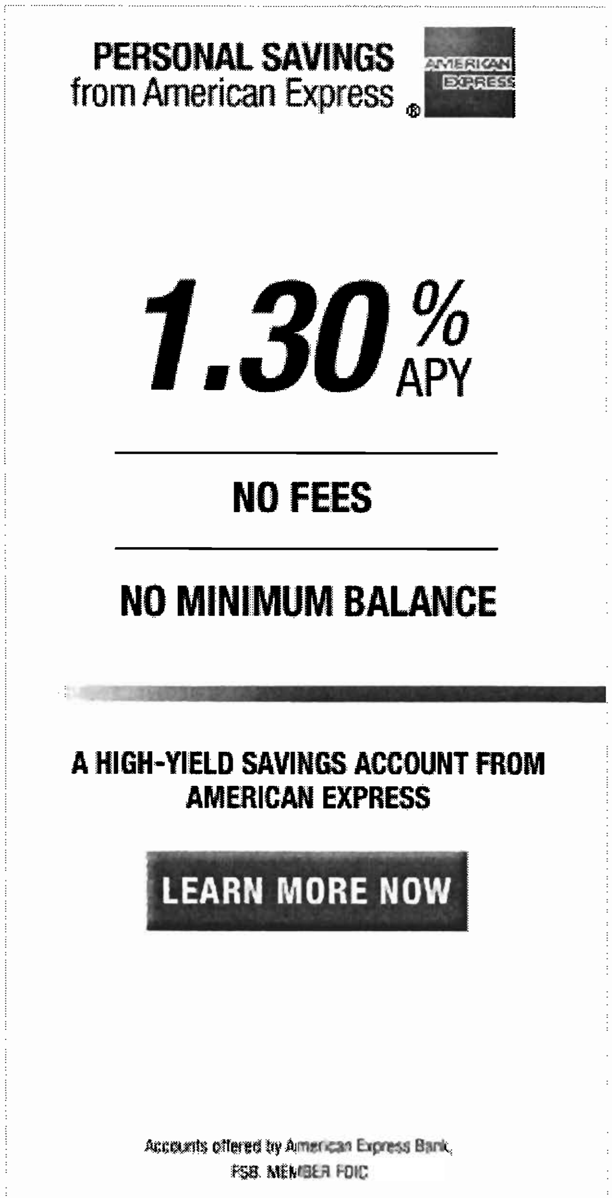

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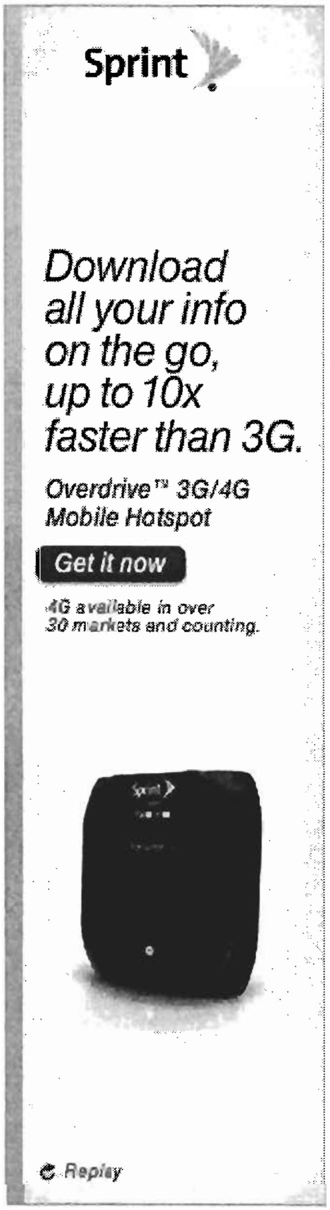

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